RUBRICS

Macro Overview

Bond Bearishness Overdone

Fixed Income Macro View

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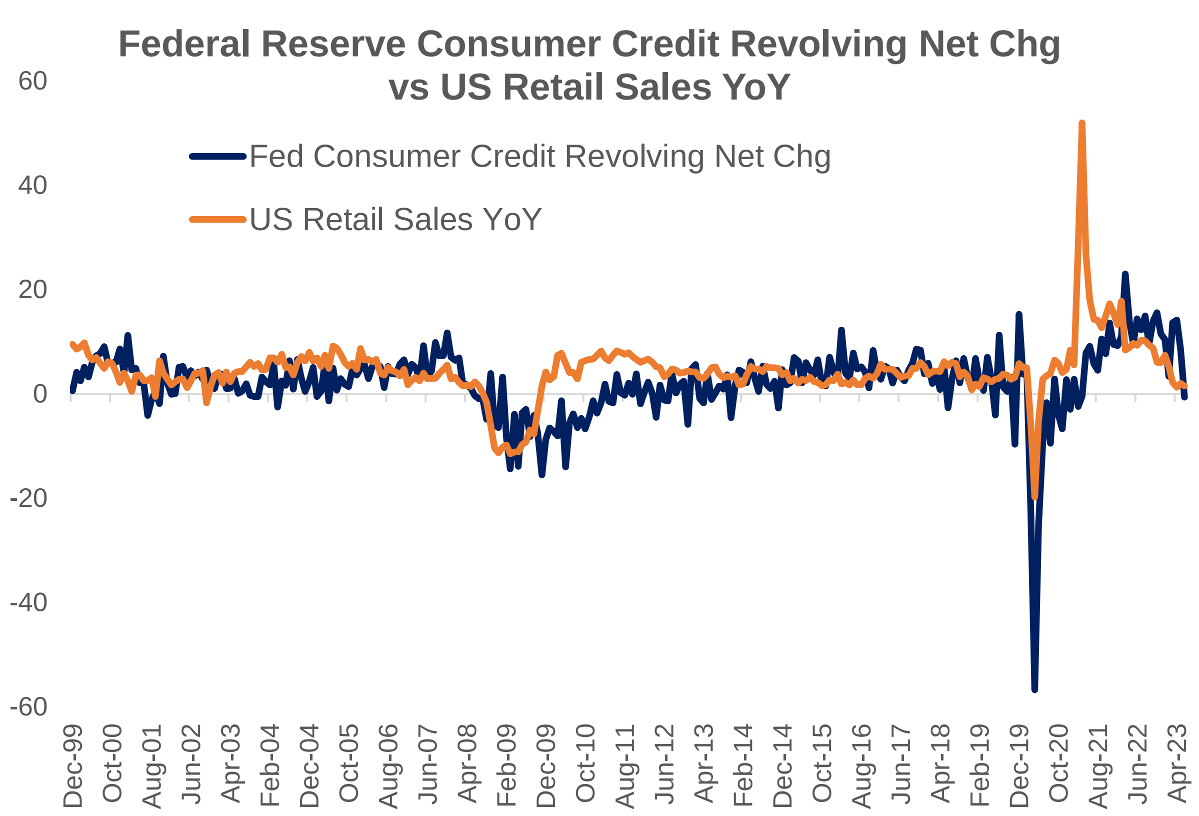
Negative Sentiment

The global heat wave has extended to the bond market this August as a steady sequence of negative news flow has dented sentiment. While we do agree with some of this as it pertains to the longer term, we do not believe the time is yet for this to play out. As things stand, higher longer-term yields driven by supply/demand imbalances should prove to be self-correcting as tighter financial conditions will ultimately result in easier policy. Below we flesh out some of the issues that we believe are causing the current bond market turmoil, while also discussing some of the factors which we feel will ultimately drive yields lower.

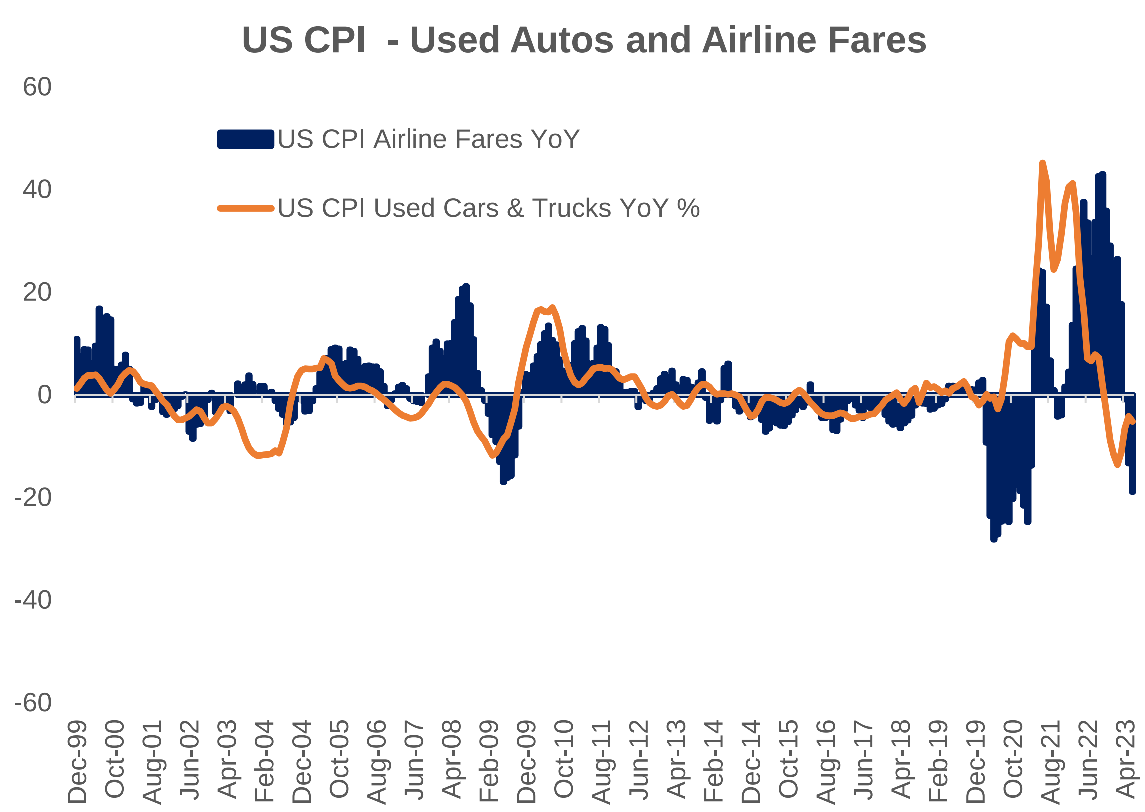
Three headlines over the last few weeks have really unnerved the bond market. First, we had the fall in tax receipts in the US leading to an increase in Treasury bond issuance. Next, we had a shift in the Bank of Japan's (BoJ) policies related to its management of its Yield Curve Control (YCC) programme, and finally we had the decision by Fitch to downgrade the US from AAA to AA+ (driven not unreasonably by both economic and political dynamics). Of the 3 factors perhaps the most significant pertains to the BoJ, as their aggressive easing of the past 2 decades has seen $trillions flow into global market assets. An unwinding of this policy, however gradual, can potentially have a sizeable impact on global markets. However, despite the sudden and unexpected increase in volatility, we do not feel it justifies a change to our overall outlook. There are several sound fundamental reasons for this.

Consumer Credit vs Retail Sales



Source: Bloomberg 31/07/23

Select Consumer Item Deflation



Source: Bloomberg 31/07/23

The Consumer - the immense momentum in the US consumer has belatedly started to slow. After months of record usage, exorbitant rates notwithstanding, credit card borrowing has begun to subside with the $1 trillion of outstanding credit card debt seemingly the high point for now. While the strong jobs market has certainly supported the consumer 'feel good' factor, employment has also begun to weaken. Although job losses are not a problem as yet, job creation has slowed markedly. Elsewhere various indicators have also started to show warnings of consumer retrenchment including second hand car prices and airline fares. While it is still early days, it looks like rates might finally be starting to bite.

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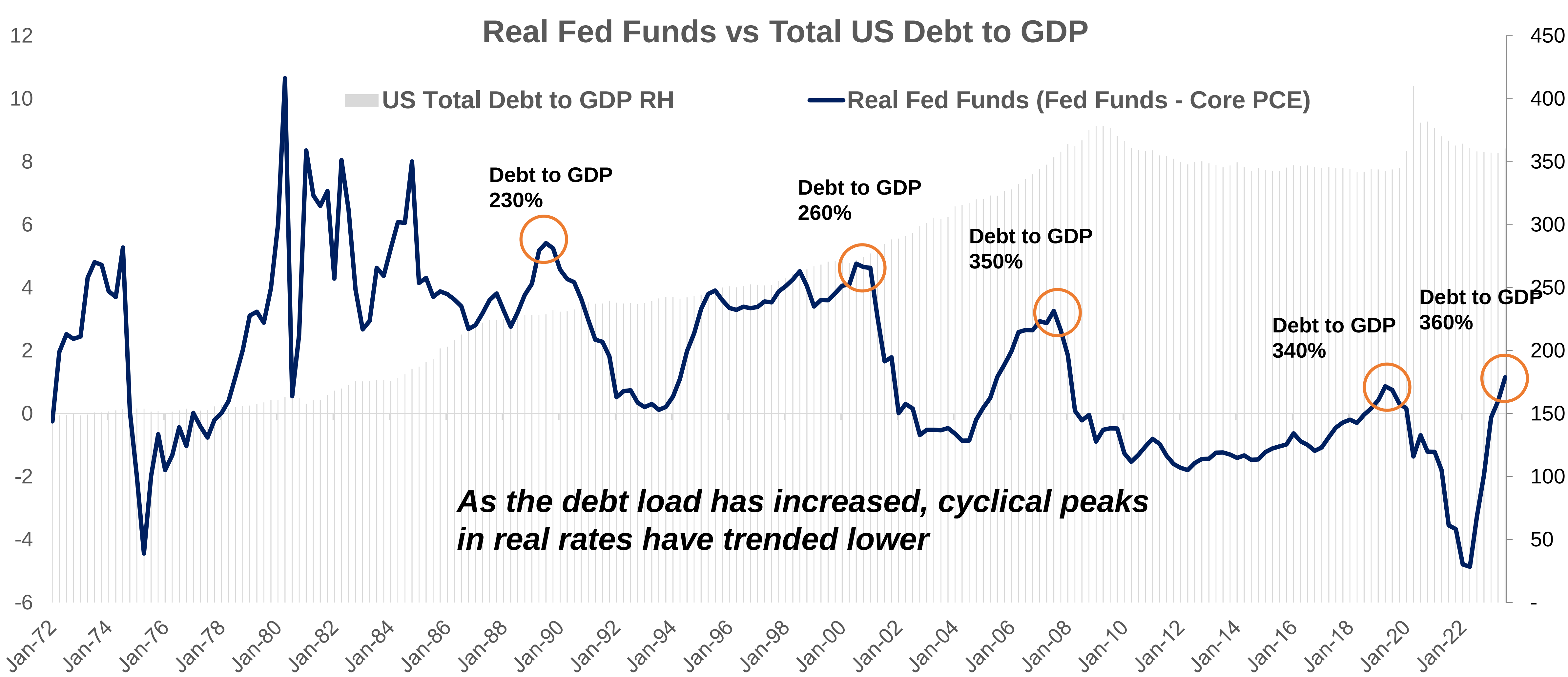
Policy Backdrop – There are longer term structural changes which we believe are likely bring about a shift from a global disinflationary regime to one of higher inflation. Practically speaking this means central banks will be more likely fighting inflation than deflation going forward. It does not mean however that we won't see cyclical disinflation/deflation on the back of efforts to undermine growing inflationary pressures. It is our belief that given the extent of monetary tightening we have seen of the last 2 years globally, that we are now moving to a period of cyclical disinflation. Even in the 1970's we saw this pattern occur. Remember it was globalisation (structural forces) more than Paul Volker's actions (cyclical) that did more to ultimately defeat inflation. The global economy of the last 30/40 years has been built on continuous credit expansion – pulling the plug on cheap money will undoubtedly have consequences and that is exactly what central banks are doing. Our advice is to read more about Newtons Laws of Physics than the views of the Nobel prize winning economists at the Fed who have failed to identify any of the many economic crisis that have occurred over the last 30 years.

Debt Controls Interest Rates

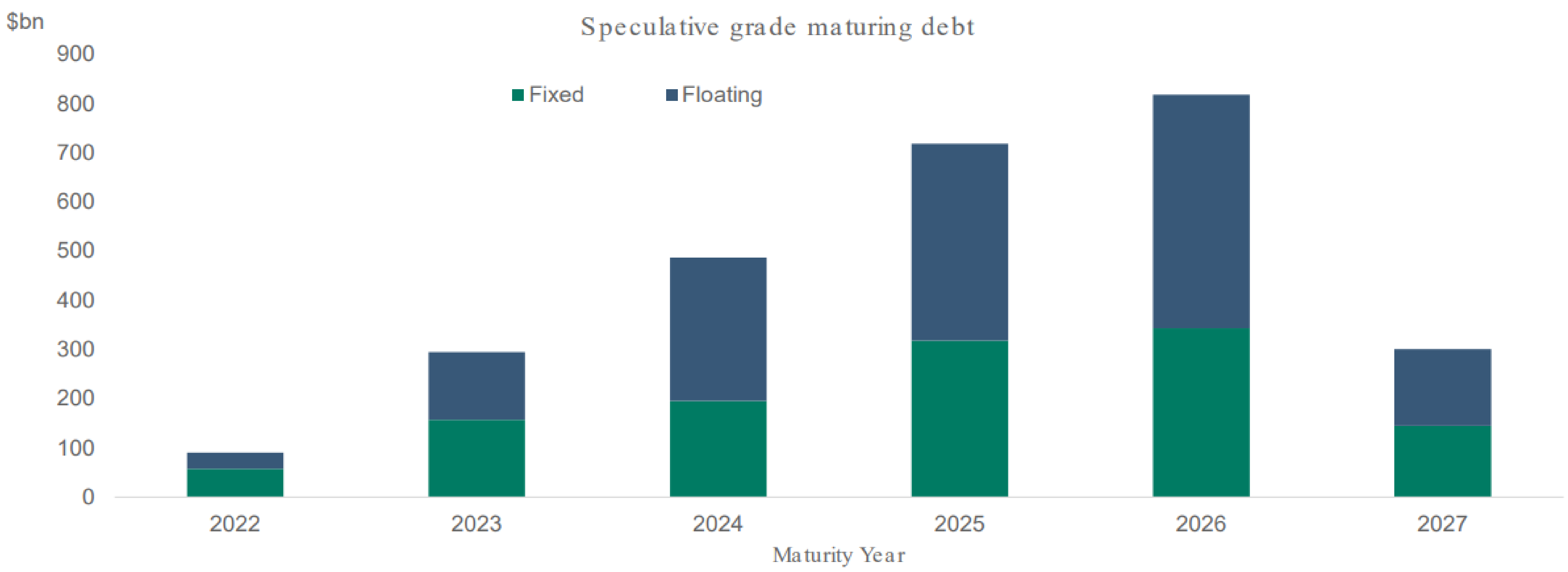


Source: Bloomberg, FRED as at 31/07/23

Debt Load - Debt is the number one factor which has determined long term interest rates and the r* (neutral rate consistent with prevailing inflation target). Debt levels can rise as interest rates drop, an experience we have lived more than any generation of consumers in the history of fiat money. However, without paying down this debt, defaulting on it, or experiencing prolonged periods of financial repression, interest rates are ultimately capped in how high than can go. Any increase above the funding ability of the economy leads inevitably to a (deflationary) correction. The drop in growth and inflation that occurs ratchets up real rates which in the end is what inflicts the most damage on the economy and financial markets. That is exactly why it is not until growth gives up that risk assets begin to reflect the true impact of interest rate hikes.

The US government has already seen the interest costs on its debt nearly double. The more debt they issue to cover these costs the more the economy will contract. This is essentially a vicious circle which doesn't stop until the economy forces down rates to the point at which it can afford to cover its costs. Now spare a thought for UK mortgage holders, many of whom will most likely face a major increase in interest payments at some time over the next two years. It is surely not unreasonable to expect that at some stage over this period the Bank of England will be facing down a sharp deflation in discretionary spending. More broadly, the amount of debt in the global financial system is completely unprecedented with much of it raised at the exceptionally low interest rates of the last cycle. While many of the larger corporates have termed out their debt maturity profiles, many issuers will have come to the market out of necessity. In aggregate terms the US corporate market is now facing a ~$2trln refinancing over the next 2 years. How many companies will be unable to stomach the higher rates? Something will likely have to give. In our view people will buy government debt and that of higher quality corporations. However, the majority of workers don't work for these global leaders – the free spending days of the US consumer might not be with us again until we can cover our interest payments.

High Yield Market Refinancing



Source: Apollo Asset Management

Global Factors - It is also important to note that the US is a component of the global economy and as such what happens abroad impacts the US eventually. China, a key driver of global growth since the early 2000s, is showing real signs of weakness. The implosion of the housing market and falling external demand cannot simply be offset by local consumption. Remember 80% of the colossal savings built up in China over the last number of decades is invested in the housing market. Europe is also fighting structural issues with Germany in particular facing an uncertain future for its key manufacturing sector. The German economy has relied heavily on exports to power its economy, recent PMI data makes for troubling reading in this regard.

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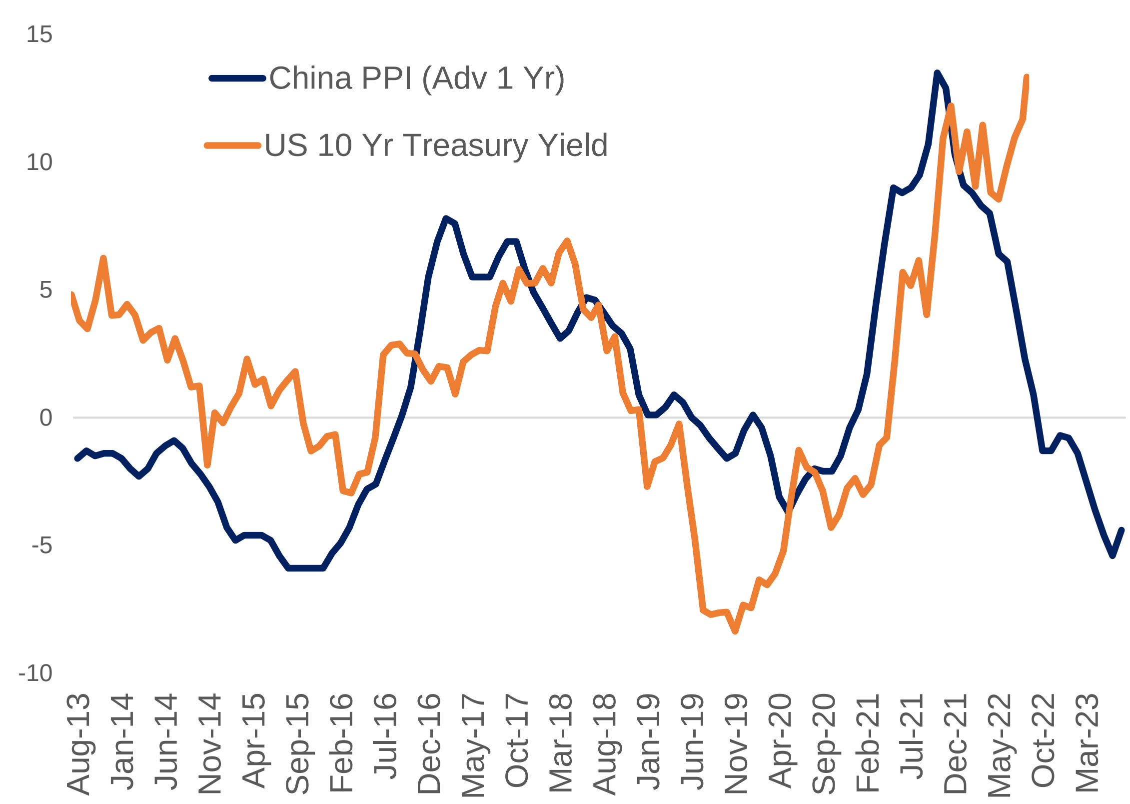
Interest rates work with a lag. Without exception, we will hear pronouncements that all is clear on the economic front before the real impact of rate hikes has really hit home. Today is no different. As we have mentioned many times before – the unpredictability of economic certainty makes our life difficult in the short run but more manageable in the medium and long term. We are seeing plenty of evidence in the credit markets that the rate hikes started only last year are beginning to bite. We believe that central banks in the west are serious about inflation and by every indication are going to do too much rather than too little to tame it.

Mortgage Market Pain

Source: Bloomberg 31/07/23

Has China Suddenly De-Coupled from the US?



Source: Bloomberg 31/07/23

In Summary

There are plenty of reasons to be concerned about our debt levels. For some it will ultimately mean default. However, the US Treasury market works in a very different way (owing largely to the status of the USD) and as such has a self-correcting mechanism built in. We see a cyclical shift in inflation due to the excessive levels of debt outstanding. Plenty of this debt is not even visible thanks to the explosion of the shadow banking industry since 2008 (the next big disaster created by our all-knowing central banks). Once the defaults move from the back page to the front page of your sell-side strategy pieces, owning Treasuries will become an attractive proposition pretty quickly and the structural issues will once again be kicked back into the long grass.

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